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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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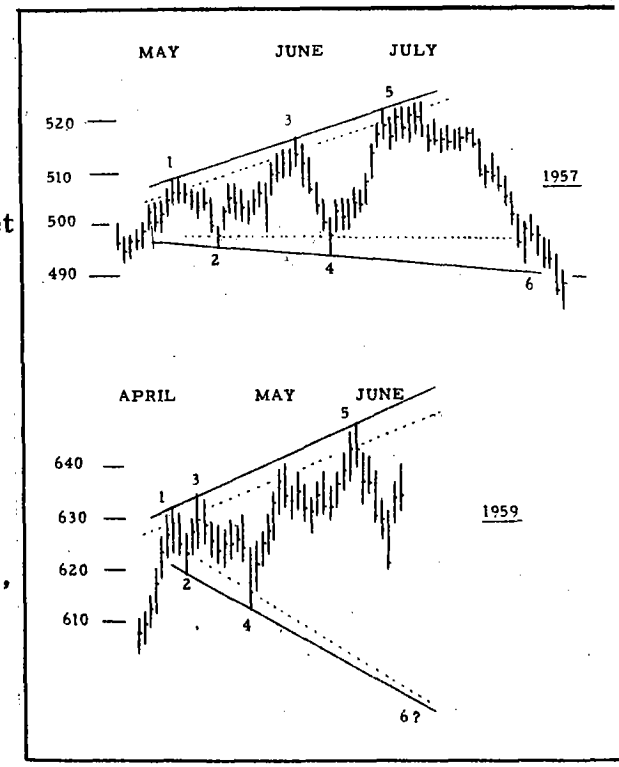
BROADENING TOP? Market history demonstrates that those who have drawn dogmatic conclusions based on "formations" in the averages have been deceived more often than not. Hamilton's only mistake occurred in 1926 when he saw a "double top" in the industrial average and thereby concluded that the bull market was over. As recently as 1956-57, analysts scrutinized the triple industrial top at 520-21 and decided that the market could never penetrate such a formidable barrier. They could not have been more wrong.



In 1957 (May-July) a formation appeared which is familiar to all students of individual stock charting; it is known as a broadening top. Because so many individual stocks developed broadening tops in 1929, this formation has always been held in awe by chartists. The appearance of a broadening formation (a series of highs and lows -- each high above the preceding high and each low below the preceding low) implies technical weakness, lack of control, and distribution. In the vast majority of cases broadening formations hold bearish connotations.

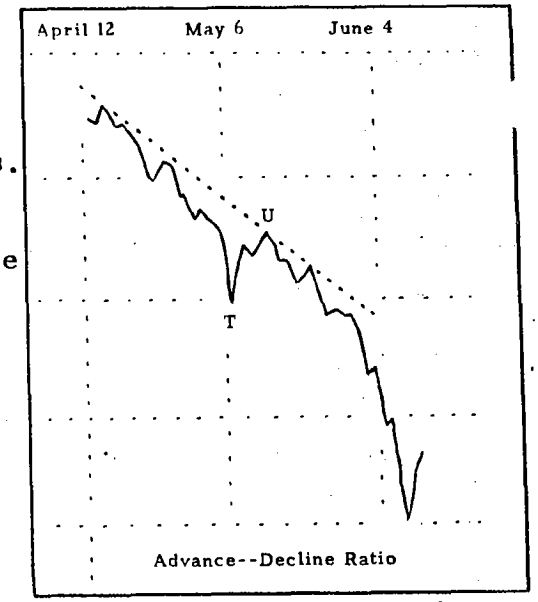
The classical broadening top is a five point reversal pattern. After the fifth reversal (pt. 5) a decline may touch the lower trendline (pt. 6). In most cases, following pt. 6 an abortive advance will retrace 1/3 to 2/3 of the distance back to pt. 5 - then peter out as volume diminishes. A final decline and violation of the lower trend line completes the pattern.

In 1957 for the first time a completed broadening top was seen in one of the averages (see diagram). The breaking of pt. 6 in 1957 was the forerunner of a drastic secondary reaction. At present another but less defined formation has caused many technicians to suspect a second broadening top (see diagram). Although pts. 1, 2, and 3 of the current pattern are minor fluctuations and are open to doubt as far as valid reversals are concerned, the whole picture bears watching. If a new decline approaches the lower trend line (pt. 6) at about 600 on the D-J industrials, it is possible that another broadening formation will have been seen. The solid trend lines of the diagrams connect intra-day points while the dotted lines connect daily closings. This study is not part of the Dow Theory, but I feel that it is interesting enough to be brought to the attention of readers.

ADVANCES AND DECLINES. Below is a moving line showing the daily ratio of total advances to total declines on the N.Y. Stock Exchange. The ratio moves up whenever advances outnumber declines and descends when declines outnumber advances. Each day's plus or minus ratio is added to or subtracted from the preceding day's figures. In this way direction is emphasized rather than mere daily points, and I find it valuable to check this direction against the "story" that the averages are telling.

Note that from the April highs, the A-D ratio fell sharply, hitting a low at pt. T (which corresponds to pt. T on our chart of the averages). But the important thing is that subse-

quent to the T lows, as the D-J averages worked to new highs (on diminishing volume and much divergence), the A-D ratio rounded over and fell away in a steep decline. It is obvious that the A-D ratio was showing weakness and thus verifying our suspicions concerning the uncertain action of the averages.



I have warned repeatedly against taking a "mechanical" reading of the averages. Those who draw inferences merely on the basis of penetrations of previous highs or lows while disregarding volume, divergences, length of moves, and phases, are certain to go wrong. The A-D ratio shows that under the disguise of new highs in the D-J averages, a great deal of distribution was taking place in the general list. How much distribution can be seen from the sharp drop of the last few weeks. Whether the selling on this drop put stocks in weaker or stronger hands will be seen in the near future.

RECENT MARKET. On January 2, 1959, the D-J industrials stood at 587.59. After five months of plodding work industrials hit a high of 643.79 (May 29, 1959). Then in the space of seven trading days almost half of the entire 1959 advance was wiped out. Compared to the long, tortuous climb, the decline was rapid and violent. Although unpleasant and costly for many, this was action typical of a primary bull market. In a bull market advances tend to be labored and prolonged; reactions tend to be sharp and violent. The exact opposite is true in a bear market. Readers might note that industrials have advanced only 3% during all of 1959 - this, in the face of a most bullish business outlook. The reason -- most of this year's good news was discounted by the market last December and January.

By all reports we are now laying the base for the "traditional summer rally". The August-September objective is said to be 675 on the D-J industrials. The current "trading range", we are told, is 610 to 640 with the 600 bottom all but "inviolate". As far as the Dow Theory is concerned, the primary trend is up, but the 600 bottom certainly has little significance for followers of the Theory.

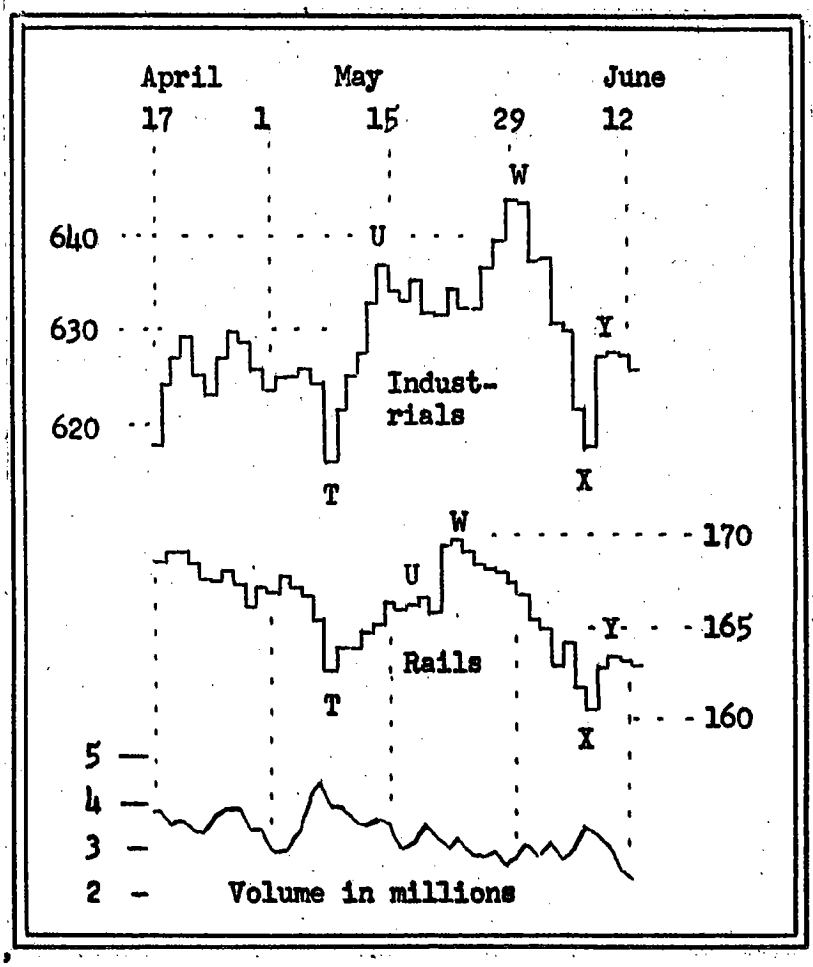
The uncorrected advance from the 419.79 lows of October, 1957, has taken industrials 224 points higher in an historic primary swing. If a full secondary were to correct this primary advance, precedent states that it would tend to retrace 1/3 to 2/3 of the entire move. This retracement could take industrials back as far as 569 (a 1/3 correction) or 494 (a 2/3 correction). I am not stating that a secondary is certain or even in the making at this time, nor am I implying that every secondary must be as severe as the average. I am saying, however, that if a secondary does appear it might not honor the predetermined "resistance levels" which have been laid out for it by market analysts and economists.

CURRENT MARKET. Following the recent decline (W-X, see chart), industrials advanced sharply (to pt. Y) retracing better than 40% of the decline. After the 26 point drop a rebound of 30-60% is normal, automatic, and to be expected. Volume on the rebound diminished each day, but this is also normal after a sharp sell-off. If, on the next decline, volume decreases and one or both averages hold above the X pts. (industrials 617.62, rails 160.46) the indications will be that the selling is over, and that a "buy-spot" has appeared (see Letter 68). But if on a decline the X pts. are violated by both averages on heavy volume a further drop and perhaps a reaction will be in the offing. I would not call a violation of the X lows on very low volume necessarily a bearish sign, but it would certainly be something to watch carefully.

Following the rebound to pt. Y, we have had two days of lower prices on extremely light volume. Although two days may not be the whole story the indications as of this writing are that the liquidation could well be over -- certainly the lower stock prices of last Friday and today (Monday) have not brought out any real volume of selling.

When the market is puzzled or hesitant, it is normal for the averages to back off to a point where they discount the worst that can be seen in the period ahead. This is the "point of safety", and pt. X could be such a spot. Following the decline to the safety level, if the market is satisfied with what it sees, then the first decline levels will hold. However, if the decline represented a well-informed period of liquidation based on a knowledge of future danger, a violation of the first lows on heavier volume is sure to occur. A breaking of the X pts. by both averages on increased volume would imply lower prices and perhaps business trouble ahead.

STOCKS. As readers know, I have not recommended stock purchases since Letter 64. I felt that the general appearance of the market did not warrent additional buying and I will venture to guess that those who refrained from making new commitments during the last month or so missed little or nothing on the profit side. Robert Rhea did a great deal of pioneering work with relative strength studies of individual stocks, and his findings were published in BARRON'S as early as 1933. Rhea noticed that different stocks outperformed the general market over a given period of time. In other words, Rhea purchased those stocks which showed superior strength relative to the market in the hopes that these stocks would continue to out-perform in the future as they had in the past.



There is much validity in relative strength studies, and often those stocks which outperform during an advance will decline least during a sell-off or reaction. The following groups have been outperforming the market on both advances and declines: HEAVY MACHINERY, TEXTILES, RUBBER, FARM MACHINERY, AUTOMOBILES. The following groups have been worse than the market: NATURAL GAS DISTRIBUTORS, AIRCRAFT, CONTAINERS, SMELTERS AND MINING, SULPHUR, GROCERY CHAINS. I suggest that any purchases be executed only on a "buy-spot" in the averages, and that purchases be confined to the relatively strong groups. Throughout April and early May the international oils looked as if they were preparing to move. But they fooled us and many are testing their older bases. Important support levels which I would not like to see broken are as follows; Standard of New Jersey -- 50, Texaco -- 75, Standard of California -- 52, Standard of Indiana -- 45-46.

Two stocks which I like for speculative purchases are CHRYSLER and WESTINGHOUSE. Both have been suggested before (at lower prices), but I believe they may be bought here.

(Written June 15, 1959 - 6 PM)

18.
23.6
41.0

5.4
13.8
19.2